BEFORE THE STATE BOARD OF EQUALIZATION

OF **THE STATE OF CALIFORNIA**

In the Matter of the Appeal of)
)
SERO AMUSEMENT COMPANY)

Appearances:

For Appellant: J. A. Cozy
Certified Public Accountant

For Respondent: Gary Paul Kane
Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of **the Revenue and Taxation Code from the action of the Franchise** Tax Board on the protest of Sero Amusement Company against a proposed assessment of additional franchise tax in the amount of $2,652.19 for the income year ended June 30, 1960. Appellant agrees that $1,208.44 of the proposed assessment is proper, and therefore only the remaining $1,443.75 is contested.

The issue presented is whether a payment made by another corporation to appellant constituted a dividend.

Appellant Sero Amusement Company, a corporation, acquired 30,000 of the 110,000 outstanding shares of common stock of the Midway Drive-In Theatre Corporation in 1953. On January 8, 1958, appellant entered into a "Stock Option Agreement" with Midway. The contract recited that differences of opinion had arisen between the parties with respect to declaration of dividends on Midway stock, that Midway desired to retire the stock owned by appellant, and under the terms set forth in the agreement appellant was willing to have its stock retired.

The agreement provided that if a payment described, as a "dividend" amounting to 87½ cents or more per share on appellant's 30,000 shares were paid by June 30, 1958, and

another like "dividend" paid by June 30, 1959, Midway would be granted an option for six months after July 1, 1959 to acquire, redeem and retire the 30,000 shares owned by appellant for $1.00 per share. The contract was subsequently amended to extend the first two payment deadline dates. Appellant also agreed to execute an irrevocable proxy in favor of the president and general manager of Midway to continue until default in payment of one of the two "dividends" or default in the exercise of the option. Sero was to be released from its contractual obligations if either of the "dividends" was not declared and paid. or if the option was not exercised.

The two so-called dividends, each in the amount of $26,250, were declared and paid to appellant within the specified time. Apparently all shareholders except appellant waived their rights to each "dividend." On December 29, 1959, the $30,000 payment was also made by Midway to appellant. During the period relevant to this appeal the book value of appellant's 30,000 shares of Midway stock ($2.82 per share, or $84,600) approximated the total amount received under the contract ($82,500). The adjusted basis of appellant's Midway stock was $27,499.

The taxability'of the second payment of $26,250 is the subject of this appeal.

Appellant contends that the payment constituted a dividend which was deductible because declared from income already taxed to the declaring corporation. (Rev. & Tax. Code, § 24402,) Respondent Franchise Tax Board contends that the payment was a partial payment in redemption of stock which was not essentially equivalent to the distribution of a dividend.

Section 24455 of the Revenue and Taxation Code, provided in 1960:

> If a corporation cancels or redeems its shares ... at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the shares? to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

In interpreting former section 115g of the Internal Revenue Code of 1939, the language of which was virtually identical to section 24455 as it read in 1960, it was long recognized that when the interest of a stockholder in a corporation is completely eliminated by the redemption of his stock the distribution is not essentially equivalent to a taxable dividend.. (Carter Tiffany, 16 T.C. 1443; Summerfield v. United States, 145 F. Supp. 104, aff'd, 249 F.2d 446; 1 Mertens, Law of Federal Income Taxation, § 9.100, p. 222,) It has also been held that when there is a series of redemptions found to be part of an integrated plan to redeem all the shares owned by a particular stockholder, a redemption which is part of the plan but does not itself eliminate the stockholder's interest is nevertheless not equivalent to a dividend, (In Re Estate of Lukens, 246 F.2d 403.) Furthermore, where after a distribution a stockholder continues as a stockholder of record as to a portion of the stock but does not retain any beneficial interest in the shares, the distribution is not regarded as essentially equivalent to a dividend. (Carter Tiffany, supra.)

It is stated in In Re Estate of Lukens, supra:

> Characteristically, a dividend is a proportionate distribution to stockholders out of earnings and profits which leaves legal ownership and control of a corporation unchanged, while a bona fide and normal redemption of stock eliminates the interest represented by that stock with a proportionate increase of the ownership rights represented by the stock which remains outstanding. In rational conception, a stock redemption can properly be treated as "essentially equivalent" to a dividend distribution only if it exhibits or is attended by significant consequences which cause it, in net effect to resemble a dividend distribution. [Citations].
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> But where the fundamental fact appears that the stockholder is surrendering his entire interest, it is a contradiction of terms to characterize the transaction as a dividend, which presupposes persisting ownership rights.

In view of the relationship between the book value of the stock and the total amount received, and considering the overall plan which resulted in the immediate surrender of voting control, the waiver of any "dividend" payments to the other stockholders, the ultimate elimination of appellant's interest, and the change in the stock interests of the other shareholders, we conclude that the distribution constituted a payment in redemption of appellant's Midway stock which was not essentially equivalent to a dividend. The device of declaring "dividends" should not be allowed to cloud the substance of the transaction. The "dividend" declarations accomplished no purpose other than distributing funds to appellant as part of a plan whereby the stock would be redeemed.

In view of our conclusion that the payments were not dividends, the amount by which the three payments exceed the adjusted basis of the stock represents gain from the sale or exchange of property. (Rev. & Tax. Code, § 24453.) Accordingly, inasmuch as the adjusted basis of appellant's Midway stock was $27,499, all but $1,249 of the second $26,250 payment constitutes taxable gain.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Sero Amusement Company against a proposed assessment of additional franchise tax in the amount of $2,652.19 for the income year ended June 30, 1960, be and the same is hereby modified to reduce the amount of gain subject to tax by $1,249. In all other respects, the action of the Franchise' Tax Board is sustained,

Done-at Sacramento, California, this 9th day of May, 1968, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary